RETIREMENT PLANNING: ANNUITIES AND WHEN THEY MAY MAKE SENSE

By William Reichenstein

Low-cost annuities can make sense when compared to taxable investments for bond investors and active stock investors with long investment horizons, especially if they expect to be in a lower tax bracket during retirement. They do not make sense for long-term buy-and-hold investors.

Individual investors are often encouraged to consider annuities of one form or another. Sometimes this comes from an insurance agent or insurance company pushing a particular annuity product, and sometimes annuity investments are part of a retirement program. Annuities are also a distribution option for retirement monies.

Annuities are complex investments that can be difficult for investors to analyze. High costs often outweigh the benefits associated with annuities. In certain circumstances, however, they can be beneficial—particularly when it comes to the distribution option for those who are living off of retirement assets.

However, in order to understand the benefits, you need to understand how annuities work. In this column (as well as my next), I will provide a primer on annuities. This first article concentrates on annuities as an accumulation option for retirement savings, focusing first on the major features in most contracts and then presenting a framework that will allow someone to decide if an annuity is right for him or her.

The next article, which will appear in the November 2003 issue, will discuss annuities as a distribution option for retirement savings, and their benefits as part of an asset allocation strategy that is concerned with the issue of ensuring that you do not outlive your available resources.

TERMINOLOGY

This section introduces terminology related to annuities. It distinguishes an investment from a savings vehicle, a qualified annuity from a non-qualified annuity, a fixed annuity from a variable annuity, and it explains what it means to annuitize an annuity.

Tax Structure vs. Investment

An annuity is a complex legal contract. Its most important feature is the tax structure facing assets placed in the annuity. It is important to distinguish the investment from its tax structure.

Suppose Judy is 50 years old and is deciding whether to invest $30,000 in a non-qualified annuity or a stock fund held in a taxable account. In either case, she will invest the funds in the ABC Mutual Fund—this is the investment. Her decision concerns whether to place that investment in an annuity or a taxable account.

If she holds the ABC Mutual Fund in the annuity, the money grows tax deferred (technically, funds held in annuities are called subaccounts). If she holds the fund in a taxable account, she will pay taxes each year on distributions.

Although the tax-deferral feature favors the annuity, it generally has higher expenses than a taxable account. Therefore, a key question is whether the benefits of tax deferral are worth the annuity's generally higher costs. Not

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Fixed Annuities: Beware of Initial Rate 'Teasers'

Ultimately, the rate of return on a fixed annuity is related to bond yields and expense ratios. After all, the return offered by the insurance firm is limited to the spread between gross bond yields and its expense ratio.

A fixed annuity is not a "security" as defined by the SEC. Therefore, its underlying expense ratio need not be (and is not) revealed.

Unfortunately, it is not always wise to select a fixed annuity based in its initial fixed rate of return. Some insurance firms may promise a high teaser rate for the initial period, which may only last one year. Then, when the low subsequent rate of return is revealed, the individual is stuck because of high surrender charges.

To reduce the chances of such bait-and-switch tactics, buy a fixed annuity from a firm that charges low expenses on variable annuities. Since variable annuities are securities as defined by the SEC, their expense ratios must be revealed. Insurance firms with low expenses on variable annuities will probably also have low expenses on fixed annuities. Monday issues of the Wall Street Journal list expense ratios on variable annuities.

surprisingly, the answer depends critically upon several factors—including the size of the annuity's cost disadvantage and the length of the investment horizon. For now, remember that, compared to a taxable mutual fund, the major benefit of a non-qualified annuity is tax-deferred growth, while a major drawback is higher costs.

Qualified vs. Non-Qualified

In a "qualified" annuity, the original investment contributions are tax deferred. Qualified annuities are annuities placed inside qualified retirement plans such as 401(k), 403(b), SEP-IRA, Keogh plans and direct IRA rollovers.

In a "non-qualified" annuity, the original investment contributions are not deductible, but returns accumulate tax deferred until withdrawal, which is usually in retirement. Let's look at why it seldom makes sense to fund a qualified plan with an annuity.

For instance, Pam recently retired and wants to roll over $500,000 in 401(k) funds into a traditional IRA—this is called an IRA rollover. One option would be to roll the funds into an IRA and, inside the IRA, invest in the QRS Mutual Fund. Since it is held in a traditional IRA, returns on the mutual fund are tax deferred.

Another option would be to roll the funds into an IRA, and inside the IRA she could buy a qualified annuity, and inside the annuity she could select the QRS Mutual Fund. However, the IRA already provides tax deferral, so the annuity's higher costs cannot be justified as the cost of providing tax-deferred growth. Therefore, it seldom makes sense to buy an annuity and place it inside a qualified plan. An exception would be one of the few qualified annuities that have costs no higher than those on low-cost mutual funds.

Fixed Annuity vs. Variable Annuity

In a fixed annuity, the individual receives a fixed rate of return for a specific investment horizon. In a variable annuity, the individual chooses among several mutual funds. He can allocate the investment funds as he chooses among a selection of stock funds, bond funds, and money market funds. The value of the annuity varies with the values of the mutual funds selected.

Annuitizing an Annuity

Annuities have two phases—the accumulation period, and the distribution period.

Let's continue with the prior example of Judy, who at age 50 invested $30,000 in the non-qualified annuity to meet her retirement needs. She is now 66 years old and ready for retirement. The annuity is worth $65,000. Here are two of her options for using the funds:

- She can withdraw as much or as little of the funds as she wants whenever she wants, or
- She can exchange the annuity for a single-life annuity that pays her a lifetime income of $416 a month.

The latter is an example of annuitization or annuitizing an annuity.

The first option provides the ultimate in flexibility. And if funds remain after her death, her beneficiaries receive the balance. However, she could also outlive her resources if she withdraws all funds before death.

The second option provides a guaranteed lifetime income, so she cannot outlive her resources. However, after her death, there would be nothing left for her beneficiaries.

Some 98% of annuity buyers do not annuitize. They buy an annuity for its accumulation feature—tax-deferred growth. They do not buy it for its unique distribution feature—annuitization.

Ironically, it is the unique *distribution* feature that can, in certain circumstances, offer several advantages as part of a retired investor's asset allocation plan. In my next column in the November 2003 issue, I'll discuss the advantages and disadvantages of annuitization.

SHOULD YOU BUY ANNUITIES?

Someone should only consider buying a non-qualified annuity if:

- They are saving for retirement, *and*
- They already have saved all they can in Roth IRAs and qualified retirement accounts such as 401(k), 403(b), traditional IRA, Keogh, SEP-IRA, and SIMPLE plans.

One disadvantage of an annuity is the 10% penalty tax that generally applies to withdrawals before age 59½. Due to this penalty, an

annuity is seldom appropriate for someone who is saving for pre-retirement needs.

In addition, the Roth IRA and qualified retirement accounts are much more tax-favored than the non-qualified annuity. [For a complete description of the various tax attributes, see William Reichenstein's article "A Look at Roth IRA Conversions and Other Taxing Issues," May 2000 *AAII Journal,* available at AAII.com.] Consequently, when saving for retirement, individuals should first fully fund their Roth IRA and qualified accounts. Then, if they want to save additional funds for retirement, they face Judy's decision of whether to save in a non-qualified annuity or a taxable mutual fund.

Due to current and scheduled increases in contribution limits to Roth IRAs and deductible pensions, few people should face the decision of whether to save in a non-qualified annuity or a taxable mutual fund.

Should You Save in a Non-Qualified Annuity or a Taxable Mutual Fund?

To compare the features of non-qualified annuities and taxable accounts, let's return to Judy, the 50-year-old single with $30,000 to invest. She walks into a retail investment-management firm with the intention of investing the funds for retirement in a stock fund. The commission-based salesman extols the benefits of an annuity. Instead of holding the stock fund in a taxable account, she could hold it (or a similar fund) in an annuity where the returns grow tax deferred; in essence, the annuity is a tax-deferred mutual fund and, he tells her, the decision to choose tax deferral instead of paying taxes each year is a 'no-brainer.' In reality, it is not quite that simple.

Table 1 presents Judy's four choices: She could buy a typical annuity, a low-cost annuity, a typical taxable stock fund, or a low-cost taxable stock fund.

The ***typical annuity*** has two major disadvantages and one major advantage. The disadvantages are high costs—which consist of insurance fees, fund management fees and an annual contract fee—and the fact that capital gains are eventually taxed at ordinary income tax rates. The major advantage is tax-deferred growth.

Table 1 lists other advantages and disadvantages. This annuity provides a return-of-premium death benefit that assures her that, should she die, her beneficiaries will receive the larger of the account's value at death or the original value of the annuity (adjusted, if necessary, for prior withdrawals); thus, the total return cannot go below zero. Another potential advantage is protection from creditors (depending on the state). In contrast, assets held in taxable accounts are not protected from creditors. This could be an important factor to medical doctors and others.

Other disadvantages of the typical annuity include liquidity impairments such as the early withdrawal penalty and surrender fees.

When compared to a low-cost mutual fund, the ***low-cost annuity*** has the same advantages and disadvantages as the typical annuity. Annual expenses typically are higher than a low-cost mutual fund. However, it has much lower costs than the typical annuity—not only are the annual expenses lower, but it

TABLE 1. FACTORS AFFECTING THE DECISION TO SAVE IN A VARIABLE ANNUITY OR TAXABLE STOCK FUND

	Typical Annuity	Low-Cost Annuity	Typical Stock Fund	Low-Cost Stock Fund
Major Factors				
Annual costs				
Total annual expense ratio	2.1%	0.7%	1.4%	0.3%
Fund expense	0.8%	0.2%	1.4%	0.3%
Insurance expense	1.3%	0.5%	na	na
Annual contract charge	$30	none	na	na
Total first-year cost	$660	$210	$420	$90
Tax-deferred returns	yes	yes	no	sometimes
Preferred cap-gain tax rates	no	no	yes	yes
Other Factors				
Liquidity				
10% early withdrawal penalty tax	yes	yes	no	no
Surrender fee	7% or less*	none	na	na
Death benefit	yes	yes	no	no
Step-up in basis	no	no	yes	yes
Protection from creditors	sometimes	sometimes	no	no

**A typical surrender fee may be 7% if withdrawn in the first year, 6% if withdrawn in the second year, 5% in the third year, and continuing until the penalty is zero for withdrawals after seven years.*

The costs for the typical variable annuity and typical mutual fund come from the January 2001 versions of Morningstar Principia Pro for Variable Annuities and Principia Pro for Mutual Funds software.

also does not impose surrender fees.

It is actually the distribution network of low-cost annuities that makes them essentially different products than the typical annuity. Typical annuities are distributed through a commission-based network of salesmen, who receive sales commissions from an insurance firm. In contrast, low-cost annuities are sold via toll-free phone numbers. Since there are no sales commissions, there is no need for surrender fees. [Monday issues of the Wall Street Journal present expense ratios on variable annuities.]

The *typical mutual fund* has lower annual costs than a typical annuity, and, if realized after one year, capital gains are eventually taxed at preferential tax rates. But returns are taxed when distributed from the fund, there are no death benefits and there is no protection from creditors. On the positive side, it is not subject to the 10% penalty tax or surrender fees. Another advantage is that assets held in taxable accounts are eligible for the step-up in basis at death; this would be unavailable to an annuity holder.

The *low-cost mutual fund* has the same advantages and disadvantages as the typical mutual fund, but with lower annual costs.

ANNUITY VS. MUTUAL FUND

This section compares investments in a low-cost annuity and a no-load, low-cost taxable mutual fund by estimating the aftertax wealth from investments in each. Knowledgeable investors should compare these low-cost alternatives. We'll also look at the probable breakeven periods—that is, the minimum investment horizon before the tax-deferral benefits of the annuity start to overcome the higher costs, allowing annuities to provide the larger ending wealth.

In this study, I assumed the following:

- Investment of $1 at the beginning of 2004.
- Gross bond returns average 5%, and gross stock returns average 8.5%, including dividend yields of 1.5% and capital gains of 7%.
- Annual expenses are 0.7% on the low-cost annuity and 0.3% on the low-cost mutual fund.
- The investor is in the 28% marginal tax bracket before and during retirement.
- Through 2008, dividends and capital gains are taxed at 15%; after 2008, dividends are taxed at ordinary income tax rates and capital gain tax rates are 20% for the active investor who realizes gains after one year and 18% for the passive investor who realizes gains at the end of the investment horizon. [This reflects the changes as a result of the 2003 Tax Act, which lowered taxes on dividends and capital gains to 15% through 2008. The examples assume the 15% tax rates will "sunset" after 2008. If the 15% tax rates are extended beyond 2008, it favors the taxable account and thus hurts the annuity by comparison.]

The proper comparison depends on the type of investor you are. For that reason, I compared the annuity against a mutual fund for different types of investors: an annuity with an underlying bond investment versus a bond fund for individuals who want underlying investments in bonds; an annuity with an underlying stock investment versus an active stock fund for active stock investors; and passive stock investments in the annuity and stock fund for passive investors.

[Some people have personal circumstances that are different from the assumptions used here. If you want to do the analyses yourself based on your own tax rate and other assumptions, check out this article on our Web site at www.aaii.com; the formulas for the accumulated returns are presented in the footnotes to Table 1.]

Comparison for Bond Investors

The annuity grows tax deferred at 4.3% (the 5% gross returns less 0.7% expense ratio). At withdrawal in 20 years, its value is $2.32 and taxes are paid on the $1.32 of deferred returns; the original $1 investment is a return of principal and tax-free.

Each year, the taxable bond fund earns 4.7% before taxes. After paying taxes at 28%, it earns 3.384%. After 20 years, the low-cost annuity and low-cost mutual fund provide the same $1.95 aftertax wealth (when rounded to the nearest penny).

Given this set of assumptions, the taxable bond fund should be preferred for horizons of less than 20 years, while the annuity should be preferred for longer horizons. Furthermore, the low-cost annuity provides substantially larger ending wealth for investors with long horizons. For example, after 40 years, the ending wealth on the annuity is $4.16 versus $3.79 for the taxable bond fund. Thus, low-cost annuities should be of special interest to younger investors.

Before leaving this section, let's compare a *typical* annuity to a low-cost bond fund. It is important to make this comparison to illustrate how poorly the typical annuity fares compared to reasonable alternatives. The analysis assumes the annuity has a 2.1% annual expense ratio, but it ignores the $30 annual fee. In the annuity, the bond grows tax-deferred at 2.9% a year (5% less the 2.1% expense ratio). After 20 years, the funds are withdrawn, taxes paid at 28% on deferred returns, and the aftertax value is $1.56. This amount is far short of the $1.95 on the low-cost bond fund. The typical annuity's 2.1% expense is like a 42% current-year tax rate. Meanwhile, the 2.9% is eventually taxed. Clearly, the low-cost bond fund's 3.384% *aftertax* return beats the typical annuity's 2.9% return *before taxes*, and the longer the investment horizon, the larger is the low-cost bond fund's advantage.

Comparison for Active Stock Investors

For the active stock investor, the appropriate comparison is the ending wealth from the low-cost annuity and the low-cost active stock fund. They are assumed to realize all capital gains each year.

These two investments provide equivalent aftertax amounts after 23 years:

- The annuity grows tax deferred at 7.8% a year. After 23 years, a $1 investment is worth $5.63, the original $1 plus $4.63 of tax-deferred returns. After paying taxes on the deferred returns the ending wealth is $4.33.
- In the taxable stock fund, during the first five years the active investor pays taxes at 15% on the 8.2% net return. Thereafter, she pays taxes each year at 28% on net dividends of 1.2% (the gross dividend yield of 1.5% less the expense ratio of 0.3%) and at 20% on the 7% realized capital gains. The taxable stock fund grows after taxes at 6.97% for five years and at 6.464% thereafter. After 23 years, its aftertax value is $4.32.

TABLE 2. BREAKEVEN PERIODS FOR LOW-COST ANNUITIES vs. LOW-COST MUTUAL FUNDS

	Income Tax Rate (%)			
	Before Retirement	During Retirement	Cap Gains Rate (%)	Breakeven Period
Bond Investors	28	28	na	20 years
	25	25	na	22
	31	31	na	17
	28	25	na	11
Active Stock Investors	28	28	15 then 20*	23 years
	25	25	15 then 20*	19
	31	31	15 then 20*	26
	28	25	15 then 20*	19
Passive Stock Investors	28	28	15 then 18**	∞
	25	25	15 then 18**	∞
	31	31	15 then 18**	∞
	28	25	15 then 18**	∞

*15% through 2008, then 20%
**15% through 2008, then 18%

∞ = Infinite: passive stock fund is always better

Comparison for Passive Stock Investors

The appropriate comparison for a passive investor is the ending wealth from the low-cost annuity and the low-cost passive stock fund. Passive investors are individuals who buy and hold passive funds. They are assumed to realize capital gains at the end of the investment horizon, with gains taxed at 18%.

The annuity, as before, produces an ending wealth of $4.33 after taxes after 23 years.

For an investor in a passive taxable stock fund, the ending wealth is $4.93 after 23 years.

In these models, the passive stock fund provides a larger ending wealth than the annuity for all investment horizons. To understand why, look at the tax treatment of the capital gain. In the annuity, capital gains grow tax deferred and are eventually taxed at 28%. In the passive stock fund, gains also grow tax deferred and are eventually taxed at 18%.

Compared to the low-cost annuity, the passive stock fund has lower expenses *and* capital gains are taxed at lower rates.

Breakeven Periods

Needless to say, the actual breakeven period for any investor varies with numerous factors including:

- The tax brackets before and after retirement,
- Whether he or she wants to invest in bonds or stocks, and
- Whether he or she is an active or passive stock investor.

Table 2 presents estimated breakeven periods using different tax rate assumptions before and after retirement.

For bond investors, as you can see from the table, for someone in the 28% tax bracket before and after retirement, the breakeven period is 20 years, while for someone in the 25% and 31% tax brackets before and after retirement, the breakeven periods are 22 and 17 years. The breakeven period falls to 11 years for someone in the 28% tax bracket before retirement and 25% after retirement. If the investor will be in a lower tax bracket during retirement, the breakeven period decreases since the annuity's income is now taxed at a lower rate.

For an active stock investor, the breakeven period is about 23 years for someone in the 28% tax bracket both during and after retirement. The breakeven periods are 19 and 26 years, respectively, for people in the 25% and 31% tax brackets before and after retirement. The longer breakeven period at higher tax rates reflects the larger spread between the capital gain and ordinary income tax rates. The breakeven period decreases if the investor will be in a lower tax bracket during retirement.

For a passive stock investor, the best choice is always the passive stock fund—the breakeven period is infinite.

CONCLUSIONS

Annuities are complex investments,

but the conclusions from this study can be easily summarized:

- Individuals should only consider buying a non-qualified annuity if they are saving for retirement and have already fully funded their Roth IRAs and qualified retirement plans such as 401(k) plans.
- Individuals should seldom consider buying an annuity and placing it inside a qualified plan.
- Knowledgeable individuals who want to save more for retirement than is allowed in Roth IRAs and deductible pensions should decide between saving in a low-cost non-qualified annuity and a low-cost mutual fund.
- *Low-cost* annuities can make sense for bond investors and active stock investors with long investment horizons, especially if they expect to be in a lower tax bracket during retirement.
- The *typical* annuity with expense ratios approaching 2% or higher is not in the best interests of investors.

Several studies by other professionals and academics support these conclusions and their authors, in written correspondence, agreed with all five of them. [See, for example, Yongling Ding and James D. Peterson, "Are Variable Annuities Right for Your Clients?" Journal of Financial Planning, January 2003; and William Reichenstein and William W. Jennings, "Who Should Buy a Non-Qualified Tax-Deferred Annuity?" in Integrating Investments and the Tax Code, 2003, John Wiley & Sons.]

Thus, there appears to be considerable agreement about the merits of non-qualified annuities and about the important distinction between low-cost and average-cost annuities. ❖

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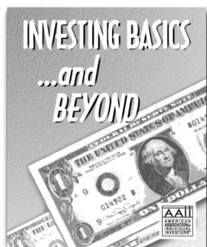

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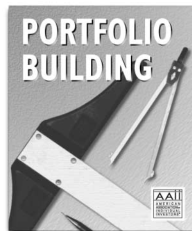

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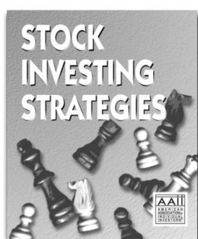

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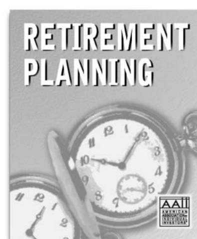

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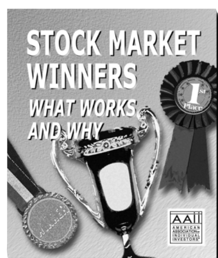

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